SECTIONS 46 (1) AND (1AA) OF THE TRADE PRACTICES ACT: THE STRUGGLE OF THE SMALL AGAINST THE LARGE

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The purpose of this article is to highlight the conflict in the policy objectives of subs 46(1) and subs 46(1AA) of the Trade Practices Act 1974 (Cth*)* (TPA). *The policy objective of subs 46(1) is to promote competition and efficient markets for the benefit of consumers (consumer welfare standard). It does not prohibit corporations with substantial market power using cost savings arising from efficiencies such economies of scale or scope, to undercut small business competitors The policy objective of 46(1AA), on the other hand, is to protect small business operators from price discounting by their larger competitors.. Unlike subs 46(1), it does not contain a 'taking advantage' element. It is argued that subs 46(1AA) may harm consumer welfare by having a chilling effect on price competition if this would harm small business competitors.*

INTRODUCTION

Measures such as s46 of the *Trade Practices Act 1974* (Cth*)* (TPA) raise issues that are intensely political. Whether they should be used for social and political objectives, such as the protection of small business, or for purely economic objectives, such as safeguarding an effective competitive process for the benefit of consumers, is a matter of public policy. The emerging consensus in most jurisdictions is that the fundamental objective of competition law should be safeguarding an effective competitive process relying on economic analysis; however, there is not complete unanimity on this issue.

The *Trade Practices Legislation Amendment Act 2008* (Cth) was the culmination of a long political struggle between those representing the interests of small business and those representing the interests of big business. It can be traced back to 2004 with the hearings by the Senate Economics References Committee into whether s 46 adequately protects small businesses from anti-competitive conduct.

The Senate Inquiry Report tabled on 1 March 2004[1] unanimously concluded that the TPA needed to be amended to protect small business from anti-competitive conduct. The Committee made six recommendations in relation to s 46 to provide for small business protection.

Prior to the last election, the Howard Government enacted the *Trade Practices Legislation Amendment Act (No 1) 2007* which created a new,

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[1] Senate Economics References Committee, 'The Effectiveness of the Trade Practices Act 1974 in Protecting Small Business' (March, 2004) (Senate Inquiry Report)

predatory pricing prohibition for the protection of small business, subs 46(1AA). Subs 46(1AA) is referred to as the 'Birdsville Amendment' since it was championed by Queensland Nationals Senator, Barnaby Joyce, and sent to his political colleagues from the Birdsville Hotel. It was hastily drafted and passed without proper consultation or debate in a last minute attempt to win over small business groups. According to Senator Joyce's Press Release dated 11 September 2007, it 'redefines the assessment of unreasonable market power and ensures that abuses of such power are outlawed for the benefit of small business.'

This new provision prohibits 'predatory pricing', defined as pricing below 'relevant' cost for a 'sustained period'. It substantially changed competition law in two important respects. First, it applies to corporations with a substantial market share rather than substantial market power. Senator Joyce and small business groups argued that proving a corporation has substantial market share would be easier than proving substantial market power. Secondly, it does not contain a 'taking advantage' element, thereby removing another of the perceived hurdles faced by small business in challenging price discounting by large firms.

Following the defeat of the Howard Government, the Rudd Government introduced the Trade Practices Legislation Amendment Bill 2008 on 26 June 2008. In relation to subs 46(1AA), the Bill proposed to remove the test of market share as the jurisdictional threshold for proceedings under subs 46(1AA) in favour of a market power test. Secondly, it proposed to re-insert a 'taking advantage' element, thereby aligning it with subs 46(1).

The Trade Practices Legislation Amendment Bill 2008 was referred to the Senate Economics Committee for inquiry. The Committee (with a majority of government members) offered qualified support for the Bill in its Report [2], over a strongly worded dissent from the Committee's opposition members. The Bill passed the House of Representatives without amendment shortly afterwards.

In the Senate, the Opposition moved amendments to the Bill to delete the proposed substantive alterations to subs 46(1AA).[3] With the support of independent Senators Fielding and Xenophon, the Opposition's amendments were successful and the Bill was passed with the amendments. Thus, subs 46(1AA) remains unchanged.

The central theme of this article is that we now have two provisions in Pt IV of the TPA with policy objectives that are at odds with each other. Subsection 46(1) promotes the competitive process for the benefit of consumers, even if this harms small business competitors. The 'taking advantage' element in subs 46(1) plays a significant role in that it makes legal the use of efficiencies by firms with substantial market power.

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[2] Senate Standing Committee on Economics, Report on Trade Practices Legislation Amendment Bill 2008, August 2008.
[3] See *Hansard,*(Senate) 15 September 2008, pp 4746-4769.

Sub-section 46(1AA), on the other hand, does not contain a 'taking advantage' element and could make it illegal for a firm with a substantial market share to use efficiencies to discount below the prices of its smaller competitors.

There may be legitimate reasons for protecting small business operators from exploitative or unfair conduct; however, this should be the primary focus of other laws such as Pt IVA of the TPA. Small business protection is not an appropriate consideration in a competition law such as s 46.

POLICY OBJECTIVES

Section 46 must be read in the context of the policy object sought to be achieved. The wording of subs 46(1) is so open-ended that there is room for differing views about its policy objectives.

During the Debates in the Senate on the Bill which became the 1974 Act, the Attorney-General, Senator Lionel Murphy, made clear that that the original intention of s46 was not to catch conduct such as price discounting that merely reflected the realisation of efficiencies:

> The provision is not directed at size as such. It is confined to conduct by which a monopolist uses the market power he derives from his size against the competitive position of competitors or would-be competitors…A monopolist is not prevented from competing as well as he is able, e.g. by taking advantage of economies of scale, developing new products or otherwise making full use of such skills as he has…In doing these things he is not taking advantage of market power.[4]

Five years later, when the TPA was reviewed to determine whether it provided adequate protection to small business, the Blunt Committee, in its Report to the Government, made a similar statement:

> It is only purposive misuse of market power and not …efficiency inspired conduct that should be at risk. Accordingly, we recommend that the purpose element should remain because we consider it is fundamental to a provision dealing with misuse of market power.[5]

The Blunt Committee concluded that Pt IV of the TPA should be directed at enhancing competition and should not be concerned with 'unfair' business conduct.

The Courts, in construing and applying subs 46(1), have continued to stress that its policy objective is to protect the competitive process to enhance consumer welfare, not to protect individuals or small business competitors.[6]

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[4] Aust, Senate, *Debates,* 14 August 1974, at 923.

[5] Trade Practices Consultative Committee, *Small Business and the Trade Practices Act* December 1979, at [9.22].

[6] In *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177, Deane J stated:

As part of the amendments to the TPA in 1995, an objects provision was inserted into the Act. Section 2 states:

> The object of the Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.

Section 2 does not mention efficiency. Does this mean that Parliament preferred competition over efficiency, or that it assumed that efficiency was inherent in the word 'competition'?

What is embraced within the term 'welfare'? The *Concise Oxford Dictionary* (8th ed) defines 'welfare' in two different ways: first, to mean 'well being, happiness; health and prosperity (of a person or a community etc); and secondly, to mean 'the maintenance of persons in such a condition…financial support given for this purpose'. In the context of s 2 of the TPA, 'welfare' does not mean a government subsidy or payment. It may mean simply 'well being'.

The economic concept of 'consumer welfare' refers to the welfare of all entities that purchase and consume goods and services – government entities, large and small business operators, as well as natural persons. Under a consumer welfare standard conduct would be assessed according to whether it was likely to lead to lower prices, better quality or more variety available to buyers, and the efficient allocation of resources to satisfy the demands of buyers.[7]

> The objective is the protection and advancement of a competitive environment and competitive conduct: *Queensland Wire* case (1989) 167 CLR 177 at 194.

Mason CJ and Wilson J also confirmed that the objective of the section is to protect consumers not competitors:

> The object of s 46 is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end: *Queensland Wire* case (1989) 167 CLR 177 at 191.

In *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1, Gleeson CJ, Gummow, Hayne and Callinan JJ stated:

> Section 46 aims to promote competition, not the private interests of particular persons or corporations: *Melway* case (2001) 205 CLR 1 at 13 [17].

In *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374, Gleeson CJ and Callinan J stated:

> The purpose of the Act is to promote competition, not to protect the private interests of particular persons or corporations. Competition damages competitors. If the damage is sufficiently serious, competition may eliminate a competitor: *Boral* case (2003) 215 CLR 374 at 411 [87].

In *ACCC v Baxter Healthcare Pty Ltd* (2007) 237 ALR 512 at 535, Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ stated that the object of the TPA was to promote competition in the public interest, not to protect governments carrying on a business and those dealing with governments in relation to those businesses.

[7] In *Re Qantas Airways Limited* (2005) ATPR 42-065 at [185] the Tribunal, adopted a total welfare standard in relation to the authorisation provisions of Pt VIII of the TPA subject to a caveat regarding the weight to be given to public benefits. The Tribunal concluded:

> In our view, the objective and statutory language of the Act, as well as precedent, support the use of a form of the total welfare standard as the most appropriate standard for identifying and assessing public benefit. We say a "form of" the total welfare standard because, … whilst the

A further source of confusion is whether the objective of 'fair trading' is intended to apply to the competition provisions in Pt IV, or only to Pt IVA (unconscionable conduct) and Pt V (consumer protection) of the Act.

In 1997, the issue of whether s 46 should be amended to catch unfair trading was debated before the Reid Committee. Chapter 6 of the Reid Report[8] is devoted to a consideration of the role played by s 46 and the inter-relationship between it and the unfair trading provisions of the TPA.

The Reid Committee concluded that s 46 was not the appropriate mechanism for dealing with unfair trading. It stated:

> The Committee considers s 46 of the *Trade Practices Act* does not address many of the problems small businesses encounter in dealing with powerful suppliers and competitors. The Committee accepts it is not appropriate to attempt to protect small businesses through the competition provisions of the *Trade Practices Act*—which are designed to engender strong competition.[9]

The Dawson Committee also concluded that no change should be made to s 46 and that the policy objective of s 46 was the promotion of competition, 'even aggressive competition' for the benefit of consumers, rather than small business protection. [10]

In 2004, the Senate Economics References Committee acknowledged that 'the wider purpose of the Act is clearly to protect competition and consumers.'[11] However, after referring to the objects provision of the TPA, the Committee stated:

> the objects of the Act …also refer to 'fair trading' which suggests that traders, including small businesses, might expect protection under the Act from 'unfair trading'. This, in turn, has led the Committee considering in this report the extent to which the Act, and in particular sections 46 and 51AC, contribute to 'fairness' in the general, everyday and common-sense use of the term.[12]

The Committee considered that 'fairness', or protecting small businesses from their larger rivals, should be one of the policy objectives of s 46(1). The Committee considered that 'while the objects of the Act refer directly to

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> Tribunal does not require that efficiencies generated by a merger or set of arrangements necessarily be passed on to consumers, it may be that, in some circumstances, gains that flow through only to a limited number of members in the community will carry less weight.

However, such a balancing exercise is not appropriate for the Courts in determining whether there has been a contravention of one of the substantive prohibitions of Pt IV of the TPA, which, prior to the enactment of s 46(1AA), was solely concerned with promoting consumer welfare.

[8]Report by the House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance: Towards Fair Trading in Australia* (May 1997) (Reid Report).
[9]Reid Report, [4.67].
[10] Review of the Competition Provisions of the Trade Practices Act, January 2003, p80.
[11] Senate Inquiry Report, p5 [1.19].
[12] Senate Inquiry Report, p8 [1.21].

enhancing competition, these objects implicitly require – or at least prefer – the existence of an effective number of competitors.'[13]

The Committee summarised its views in the following passage:

> the purpose of the Act is to protect competition. This can best be achieved by maintaining a range of competitors, who should rise and fall in accordance with the results of competitive rather than anticompetitive conduct. This means that the Act should protect businesses (large or small) against anticompetitive conduct, and it should not be amended to protect competitors against competitive conduct.[14]

The policy objectives of s 46 are now buried in the semantics of the Senate Inquiry Report. As well as the long-standing consumer welfare objective, subs 46(1AA) incorporates a new policy objective of small business protection. Such a policy will not maximise consumer welfare. Rather, it could detract from it by inhibiting healthy competition. Small business protection may eventually trump efficiency in s 46 cases.

Thus, in construing subs 46(1AA) and the new subs 46(6A) it may be open to a court to have regard to the policy objective of 'fairness' in s 2 of the TPA in terms of equality of opportunity for all market participants and 'small business protection', rather than promoting strong competition and efficiency for the benefit of consumers.

TAKING ADVANTAGE AND EFFICIENCY

Unlike the other substantive prohibitions in Pt IV of the TPA, where the anti-competitive conduct is defined in considerable detail, s 46 is drafted in broad terms and gives no guidance as to the categories of conduct that may be caught. Such a broad, open-ended legal standard leaves considerable scope for 'evaluative and purposive judgments' and taking into account any expressed policy objective.[15]

The wording of s 46 has never addressed efficiency directly. Instead, the courts have factored efficiency into the 'taking advantage' element of s 46(1) applying the policy that underlies the law.

Since the High Court's decision in the *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd*, the 'taking advantage' element has been regarded as an objective test. The test is whether the conduct involves a use of the market power, in the sense of a causal link between the conduct at issue and the market power.[16] A counter-factual is specified in which the

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[13] Senate Inquiry Report, p5 [1.22].
[14] Senate Inquiry Report, p6 [1.26].
[15] Justice R S French, "Dolores Umbridge and policy as legal magic" (2008) 82 *Australian Law Journal* 322 at 330.

[16] In *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177, Deane J stated that the objective of s 46 is not concerned with moral issues such as equality and fairness , but economic issues:

respondent does not hold the same degree of market power and an assessment is made as to whether it would engage in the same conduct without that market power.

If the conduct is consistent with the way a firm would be expected to behave under competitive conditions, then the requisite causal link is absent.[17]

The critical feature of a misuse of market power is said to be this connection between the conduct and the respondent's market power, in the sense that the defendant used its market power to bring about the conduct.

Proof of the taking advantage element has required the input of expert economists, and in expressing their views they have generally considered whether the conduct is efficiency enhancing or not. Efficiencies can arise in a variety of ways not just from economies of scale or economies of scope, but also from vertical practices or vertical integration and reducing transaction costs.

If the conduct at issue is efficiency enhancing, it does not involve a use of market power since this is the way one would expect firms to behave under competitive conditions.

Frances Hanks and Philip Williams have argued that the decision of the High Court in *Queensland Wire* placed economic efficiency 'at the heart' of deciding whether conduct constitutes 'a taking advantage of market power' for the purposes of s 46.[18] They point out that BHP's refusal to supply the intermediate product, Y-bar to QWI was not justified in terms of efficiencies arising from vertical integration or economies of scope:

> In *QWI* there was no evidence of any economies of scope from having the manufacture of the Y-bar conducted by the same management as that which processed the Y-bar into star-picket fence posts. Indeed, all the Y-bar feed was produced in Newcastle. This feed was transported hundreds of miles to Kwinana in Western Australia and to Brisbane in Queensland – as well as to a separate processing plant in Newcastle – before conversion into star-picket fence posts.'[19]

However, it would not have been a 'taking advantage' of market power for a single-firm monopolist producer of glass bottles to refuse to supply molten

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'The essential notions with which s 46 is concerned and the objective which the section is designed to achieve are economic not moral ones. The notions are those of markets, market power, competitors in a market and competition.

[17] *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1 at 21 [44]. The High Court majority was concerned with economic efficiency rather than the protection of individual competitors. See [20] where it acknowledged that non-price vertical restraints on distributors may result in distribution efficiencies that increase inter-brand competition even though they decrease intra-brand competition.

[18] Hanks F and Williams P, "Implications of the Decision of the High Court in Queensland Wire" (1990) 17 *Melbourne University Law Review* 437 at 446. See also Brunt M, *Economic Essays on Australian and New Zealand Competition Law* (Kluwer Law Int'l, 2003), 30–35, 334–336.

[19] Hanks F and Williams P, "Implications of the Decision of the High Court in Queensland Wire" (1990) 17 *Melbourne University Law Review* 437 at 451.

glass to a potential competitor, because of '…the inefficiencies (that is, increases in costs) caused by breaking the process of production at the stage of the molten glass.'[20]

Another example of this principle is provided by the High Court majority in the *Melway* case, in which Melway adopted a distribution system that gave rise to distribution efficiencies.

The High Court majority cited[21] with approval the decision of the United States Supreme Court in *Continental TV Inc v GTE Sylvania Inc,*[22] where the Supreme Court held that economic efficiency may enhance competition.

In that case, the Supreme Court stated:

> Vertical restrictions promote inter-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. Because of market imperfections such as the so-called 'free-rider' effect, services…might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did.[23]

This reasoning influenced the High Court in deciding that it was not a taking advantage of Melway's market power to set up an exclusive wholesale distribution system that gave rise to distribution efficiencies.

McHugh J, in *Boral Besser Masonry Ltd v ACCC,*[24] drew attention to the role played by the 'taking advantage' element in protecting price reductions that derive from efficiency against allegations of predatory pricing.

> Section 46 would be a vehicle for anti-competitive conduct if the most efficient firm in the market had substantial market power and by reason of its efficiency could not take market share from its rivals without contravening the section. This makes little sense from the perspective of achieving an efficient economy with efficient resource allocation or for the benefit of consumers who can be provided with quality goods or services at lower prices. In a competitive market, the more efficient firms can produce more (because their average costs are lower) and obtain a greater share of the market with the result that they substantially damage their less efficient competitors. Such firms can expand their production until their marginal cost equals the market price. No one would suggest that an efficient firm with market power breaches the section because it increases its output to the level of its marginal cost. Yet the firm has market power, has substantially damaged its competitors and by intentionally increasing its output must have acted for a proscribed purpose. It does not breach s 46, however, because it has not "taken advantage of" its market power. [25]

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[20] Hanks F and Williams P, "Implications of the Decision of the High Court in Queensland Wire" (1990) 17 *Melbourne University Law Review* 437 at 445.
[21] (2001) 205 CLR 1 at 14 [20].
[22] 433 US 36 (1977) at 55-56.
[23] *Continental TV Inc v GTE Sylvania Inc* (1977) 433 US 36 at 54.
[24] (2003) 215 CLR 373.
[25] (2003) 215 CLR 373 at 464-465 [280].

In *RP Data Ltd v State of Queensland* [26] Collier J had to decide whether the respondent had taken advantage of its substantial market power in the Wholesale Market for the supply of data relating to the names, addresses, real property descriptions, sales, valuation and ownership of real property interests in Queensland, by excluding the names and addresses from the bulk data supplied to RP Data Ltd and other licensees operating in the Retail Market.

An expert economist, Dr Williams, in his report, stated that data on names and addresses are critical for a number of users in the Retail Market, and that if the Wholesale Market had been competitive, the respondent would have been unlikely to withdraw this data, because any refusal to supply by the respondent would have been met by a third party.[27] Furthermore, the removal of the data could not be explained in terms of efficiencies forced by competition.

In the light of this evidence, Collier J concluded that the respondent had taken advantage of its market power in the Wholesale Market in withdrawing the excluded data from supply to the applicant.[28] However, the respondent did not have an anti-competitive purpose in doing so. The applicant and the respondent were not rivals in the Retail Market who were striving to outdo each other. Rather, the respondent's purpose was to protect the privacy of the real property owners and prevent the misuse of the data for direct marketing by real estate agents.[29]

2008 AMENDMENTS: PREDATORY PRICING

Predatory pricing is now prohibited by two separate provisions, subs 46(1) and subs 46(1AA). The purpose of this part is to identify some of the uncertainties that surround the current tests and to compare the Australian position with the recently announced predatory pricing tests adopted by the Antitrust Division of the United States Department of Justice[30] and the EC Commission.[31]

In the past, firms with substantial market power have been permitted to realise efficiencies not available to small business competitors and to under-cut them without contravening subs 46(1). Prior to the 2008 amendments the leading case on on what constituted predatory pricing for the purposes of subs 46(1) was *Boral Besser Masonry Limited v ACCC.*[32]

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[26] (2007) ATPR 42-197.
[27] (2007) ATPR 42-197 at [108] 48,272-3.
[28] (2007) ATPR 42-197 at [114], 48,274.
[29] (2007) ATPR 42-197 at [143], 48,279 and [174], 48,287
[30] U.S. Department of Justice, *Competition and Monopoly: Single-firm Conduct Under s 2 of the Sherman Act* issued on 8 September 2008 available at the Department's website at: http://www.usdoj.gov/atr/public/reports/236681/pdf.
[31] Commission of the European Communities, Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings issued on 3 December 2008 available at the EC Commission's website: http://ec.europa/eu/competition/antitrust/art82/guidance.pdf.
[32] (2003) 215 CLR 374.

Gleeson CJ and Callinan J, who formed part of the majority in the *Boral* case expressed a cautionary note about adopting cost-based tests in Australia:

> Section 46 does not refer specifically to predatory pricing, or recoupment, or selling below variable or avoidable cost. These are concepts that may, or may not, be useful tools of analysis in a particular case where pricing behaviour is alleged to contravene s 46. Care needs to be exercised in their importation from different legislative contexts.[33]

Later in their judgment their Honours noted that if prices are fixed as a result of competitive market pressure, then a finding that prices are below variable costs is inconclusive:

> [T]here is nothing in s 46 that, as a matter of law, requires a distinction to be drawn between pricing below or above variable or avoidable costs. As has already been observed the distinction is unsatisfactory. Furthermore, in the present case it is of limited utility. For some, but not all, of the relevant period, prices charged by BBM were below BBM's variable costs if no adjustment or allowance is made for the position of the wider Boral group.
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> …
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> To observe, as a matter of objective fact, that BBM's prices were lower than BBM's variable costs is inconclusive if the prices were fixed as a result of competitive market pressure. [34]

This latter point was also made by Gaudron, Gummow and Hayne JJ who formed part of the majority:

> [P]redatory price cutting is commonly distinguished from defensive price cutting, such as the cutting of prices in response to changed market circumstances including a drop in demand, which requires some new strategy if the firm in question is to survive …' [35]

McHugh J observed:

> In my view, what is required is not a bright line rule about costs but a more sophisticated analysis of the firm, its conduct, the firm's competitors, and the structure of the market not only at the time in which the firm has engaged in the conduct allegedly in breach of the Act but also before and after that conduct. [36]

There are both conceptual and practical difficulties with cost-based tests. Economists disagree about which costs are variable. Manufacturers and suppliers rarely have product costing systems in place that allow them to calculate the total cost or average variable cost of a particular product they produce. There are problems involved in the allocation of common costs. To

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[33] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 420 [124].

[34] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 421 [128].

[35] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 434 [171].

[36] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 462 [273].

oblige firms to keep such records would impose a substantial cost burden on firms.[37]

The High Court majority held that while the prospect of recoupment was not legally essential to prove a contravention of s 46, it might be of factual importance in determining whether the price cuts are the result of competitive market pressure (defensive price cuts) or a use of market power. However, the need to establish that the respondent expected to be able to recoup its losses in subsequent trading was left open.

Gleeson CJ and Callinan J stated:

> While the possibility of recoupment is not legally essential to a finding of pricing behaviour in contravention of s 46, it may be of factual importance. The fact, as Heerey J found, that BBM had no expectation of being in a position to charge supra-competitive prices … was material to an evaluation of its conduct … the ACCC originally endeavoured to make out a case involving at least conscious parallelism between BBM and Pioneer. That attempt failed. If it had succeeded, the case may have taken on a different complexion. [38]

Gaudron, Gummow and Hayne JJ agreed that a reasonable prospect of recoupment was not an essential element, but may be of some evidentiary value in determining whether a firm has market power. If the firm has prospects of recoupment this may indicate that there are barriers to new entry.

According to their Honours,

> [I]t would, at least at an evidentiary level, be appropriate to consider what in the United States decisions is treated as "recoupment".[39]

McHugh J considered that the recoupment test had a significant role to play in distinguishing between competitive discounting and predatory pricing:

> Recoupment involves the capacity of a firm to price in a manner inconsistent with what a competitive market would dictate in order, at a minimum, to make good the losses sustained during the price war. Although a firm may seek not only to recoup its losses but also to earn monopoly profits, at a minimum a clearing of the losses would be required to make the conduct rational. The greater the degree of recoupment that a firm can achieve, the greater is its market power. But a firm that is unable to recoup any of its losses has no market power. [40]

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[37] In order to detect anti-competitive bundling telecommunications carriers are being forced to comply with new record keeping practices to ensure transparency. The information will enable the ACCC to calculate whether the retail price for a particular product is a true reflection of the cost of providing that product.

[38] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 422 [130]-[131].

[39] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 440 [191].

[40] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 468 [289].

McHugh J explained the analytical advantage of treating recoupment as an element in determining a claim of 'predatory pricing':

> [Recoupment] provides a simple means of applying s 46 without affecting the object of protecting consumer interests. It enables a court to avoid getting into the messy area of cost analysis, examination of various accounting figures and competing expert evidence on the question of what are the relevant costs. A recoupment test requires the court to examine the market structure—something the courts have had less difficulty with than with cost analysis—and determine the ability of a firm to recoup its losses from its price-cutting.
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> …
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> It is only when the market structure is such that a firm could recoup, that courts will need to consider the relationship between price and cost.[41]

Predatory pricing : subs 46(1)

The 2008 amendments now expressly provide that in determining whether there has been a contravention of subs 46(1), selling at below relevant cost for a sustained period is relevant, but proof of recoupment is not necessary.

The following matters will need to be considered in assessing whether below cost pricing contravenes subs46(1)

- **Substantial market power**

Did the respondent have *substantial market power* at the time of the intense price competition? The relevant factors for determining whether the respondent has substantial market power are the extent to which it is constrained by the conduct of actual or potential competitors, its customers or its suppliers.[42] The respondent may have substantial market power even though it does not substantially control the market, or enjoy 'absolute freedom from constraint' from the conduct of actual or potential competitors, its customers or its suppliers.[43] More than one corporation may have a substantial degree of power in a market.[44]

Substantial market power is defined in terms of the ability to raise prices profitably above the competitive level without rivals taking away customers in due time.[45] In *Boral Besser Masonry Limited v ACCC*, Gleeson CJ and Callinan J stated:

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[41] *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at 469-70 [292].

[42] Sub-s 46(3). See *Boral Besser Masonry Limited v ACCC* (2003) 215 CLR 374 at [121] (Gleeson CJ and Callinan J) and the commentary by Niblett A Gans J and King S, "Structural and Behavioural Market Power under the Trade Practices Act" (2004) 32 *Australian Business Law Review* 83 at 94-5.

[43] Sub-s 46(3C).

[44] Sub-s 46(3D).

[45] See *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Company Limited* (1989) 167 CLR 177 at 188.

> Pricing may not be the only aspect of market behaviour that manifests power. Other aspects may be the capacity to withhold supply, or to decide the terms and conditions, apart from price, upon which supply will take place. But pricing is ordinarily the critical test.[46]

Furthermore, Gleeson CJ and Callinan J stated that:

> Financial strength is not market power, although if a firm has market power, its financial resources might be part of the explanation of that power. The financial ability to survive a price war is not market power, or a manifestation of characteristics that give market power, if, when the price war is over, the market is still highly competitive. Power in a supplier ordinarily means the ability to put prices up, not down.[47]

In *Universal Music Australia Pty Ltd v ACCC,* the Full Court accepted[48] the findings of Hill J that it was 'commercially imperative' for retailers to stock the Australian catalogue of each of the major distributors and that a refusal to supply would cause a retailer considerable inconvenience and loss of sales and profits. However, this was not enough to demonstrate substantial market power. The Full Court held:

> Market power is judged by reference to persistent rather than temporary conditions.[49]

A similar view about the need to assess market power over the longer term was taken in *Australian Gas Light Company v ACCC (No 3)*.[50] AGL, a major retailer of electricity and gas in the national electricity market sought a declaration that its acquisition of a 35% interest in Loy Yang Power (LYP), a major generator of electricity in Victoria was not likely to have the effect of substantially lessening competition. There was evidence that during the summer of 2000/2001, LYP embarked on a deliberate strategy of bidding its capacity in such a way as to increase spot prices.[51]

Nevertheless, French J held that this was not evidence of market power:

> In my opinion the market tactics here being discussed assume the character of something that looks less like the exercise of market power than moderately well informed betting on the market. … no doubt, as Victoria's largest generator, it is in a position opportunistically to respond to

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[46] (2003) 215 CLR 374 at [136]. See *Austrac Operations Pty Ltd v State of New South Wales* (2003) ATPR 41-960 where Austrac alleged that the State of New South Wales and FreightCorp contravened subs 46(1) by engaging in predatory pricing. Emmet J concluded at [37] FreightCorp did not have a power to increase prices, or to impose terms, or to reduce supply within the meaning of s 46(1).
[47] (2003) 215 CLR 374 at [138].

[48] (2003) 131 FCR 529 at 565 at [153].

[49] (2003) 131 FCR 529 at 568 [158].
[50] (2003) 137 FCR 317.
[51] *AGL* case (2003) 137 FCR 317 at 443 [437].

> supply/demand imbalance in very short time intervals and if all the variables are in the right place, to affect both spot and forward contract prices. The question is whether the existence of such opportunities and the fact that it responds to them from time to time reflects the existence of market power. There is a distinction to be drawn between what was referred to as "transient market power" and "persistent but intermittent" market power.[52]

French J concluded that the existence of substantial market power needs to be assessed over a period of years rather than months, and certainly not the half-hourly price spikes which the ACCC argued demonstrated the exercise of market power. Over the longer term (two years), French J found[53] that barriers to entry into electricity generation were relatively low and that gas turbines are able to be commissioned in 'under two years'.

In summary, an assessment of the substantial market power standard requires an analysis of the structure of the market and, in particular barriers to entry, over the longer term. Even in a competitive market structure, a firm may enjoy temporary market power because of a lack of information about price variations between suppliers. In the longer-term however, such price variations will tend towards uniformity. A position of substantial market power requires the existence of long-run barriers to competition and the timeframe for such an assessment is likely to be years rather than months.

- **Selling at less than relevant cost for a sustained period**

Did the respondent supply goods or services 'for a sustained period at a price that was less than the relevant cost to the corporation of supplying the goods or services'?[54] No guidance is provided as to what is the 'relevant cost' of supplying the goods or services or what amounts to a 'sustained period'. The 2008 amendments do not specify which measure of cost is the 'relevant' cost. A number of different cost standards have been proposed in the economic literature, including

- average total cost;
- marginal cost;
- average variable cost;
- long-run average incremental cost; and
- average avoidable cost.

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[52] *AGL* case (2003) 137 FCR 317 at 447 [456].

[53] *AGL* case (2003) 137 FCR at 430 [391].
[54] Sub-s 46(4A).

Avoidable cost was adopted as the relevant cost in the *Boral* case by the primary judge. Heerey J provided the following example to illustrate these different cost measures:

> The concept of avoidable cost may be illustrated by the following example. Assume that to make an article a firm has to pay $6 for raw materials and incurs fixed costs of $4. Thus a sale for any price above $10 will return a profit. If the firm sells for $8, it will sell below cost and accordingly make a loss. But it will recover its raw materials costs and make a contribution to its fixed costs. So the firm is better off making the article than not making it. But if the price received is less than $6 the firm is worse off. It would be better not to make the article. In this example $6 is the avoidable cost, the cost that will be avoided by not making the article. The term variable cost is often used as a synonym for avoidable cost, and was in the present case. In strict economic theory there are differences, but they are not material for present purposes.[55]

In the High Court, Gleeson CJ and Callinan J observed that it may be an over-simplification to conclude that BBM should not produce the article if it could not recover its avoidable cost:

> To conclude that, in the example just given, BBM would be better off not to make the article than to supply it at $6, may leave out of account many legitimate business considerations. First, as already noted, there were benefits to the wider Boral group, both tangible and intangible, from BBM continuing to supply CMP. Secondly, even limiting consideration to BBM, it could make business sense to bear short-term losses in the hope that market conditions would improve. Thirdly, the alternative considered in BBM's strategic planning, as will appear, was to withdraw from the market. The costs involved in that are not taken into account in the comparison urged by the ACCC. The appropriate method of paying regard to so-called sunk or historic costs of investment is a fourth matter which does not here, but may, at some future time, call for consideration.[56]

According to the Antitrust Division of the United States Department of Justice the emerging consensus is that average avoidable cost is the most appropriate cost measure to evaluate predation claims, '…because it focuses on the costs that were incurred when the predatory pricing was pursued.'[57]

Average avoidable cost is the cost of making the predatory sales. The cost is not measured over the entire output but only the additional output used to make the predatory sales. This might include an element of fixed costs if, for example, the factory had to be expanded to produce the predatory increment when the new firm entered. The Antitrust Division defines average avoidable cost as consisting of:

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[55] Adopted by the primary judge, Heerey J, *ACCC v Boral Ltd* (1999) 166 ALR 410 at 431 [104]. See *Boral Besser Masonry Ltd v ACCC* (2003) 215 CLR 374 at 406-408 [68]-[72] (Gleeson CJ and Callinan J).

[56] See *Boral Besser Masonry Ltd v ACCC* (2003) 215 CLR 374 at 407 [70] (Gleeson CJ and Callinan J).

[57] U.S. Department of Justice, *Competition and Monopoly: Single-firm Conduct Under s 2 of the Sherman Act* issued on 8 September 2008 at 65. Available at the Department's website at: http://www.usdoj.gov/atr/public/reports/236681/pdf.

> …all costs, including both variable costs and product-specific fixed costs, that could have been avoided by not engaging in the predatory strategy. Unlike long-run average incremental cost, average avoidable cost omits all fixed costs that were already sunk before the time of the predation; consequently, average avoidable cost will generally be lower than long-run average incremental cost.[58]

According to the EC Commission:

> The cost benchmarks that the Commission is likely to use are average avoidable cost (AAC) and long-run average incremental cost (LRAIC). Failure to cover AAC indicates that the dominant undertaking is sacrificing profits in the short term and that an as efficient competitor cannot serve the targeted customers without incurring a loss. LRAIC is usually above AAC because contrary to the latter (which only includes fixed costs if incurred during the period under examination), it includes product specific fixed costs made before the period in which allegedly abusive conduct took place. Failure to cover LRAIC indicates that the dominant undertaking is not recovering all the (attributable) fixed costs of producing the good or service in question and that an as efficient competitor could be foreclosed from the market.[59]

In practice, however, it may not be possible to isolate the additional output (predatory increment) or to identify the additional cost incurred in producing it. Accordingly, average variable cost is sometimes used as a surrogate for avoidable cost. Variable costs are costs which vary with changes in output (for example, materials, energy, labour, repair and maintenance). As long as a firm's price exceeds its average variable cost, it should be presumed to be lawful. If a firm's revenues are less than average variable costs, it should be presumed to be unlawful.

- **Taking advantage of market power**

Did the respondent 'take advantage' of its substantial market power? This requires a consideration of the counter-factual approach already discussed and would allow the court to take into account whether the respondent was merely passing on cost savings arising from efficiencies.

- **Recoupment not necessary**

The respondent may contravene subs 46(1) even if it '…cannot, and might not ever be able to, recoup losses incurred in supplying the goods or services.'[60]

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[58] U.S. Department of Justice, *Competition and Monopoly: Single-firm Conduct Under s 2 of the Sherman Act* issued on 8 September 2008 at 64. Available at the Department's website at: http://www.usdoj.gov/atr/public/reports/236681/pdf.

[59] Commission of the European Communities, Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings issued on 3 December 2008 at [25], 11. Available at the EC Commission's website: http://ec.europa/eu/competition/antitrust/art82/guidance.pdf.

[60] Sub-s 46(1AAA).

It would seem that evidence that recoupment is probable or likely may assist in establishing a contravention of subs 46(1).

- **Prohibited purpose**

Did the respondent have a subjective *purpose* of eliminating or substantially damaging a competitor, preventing the entry of a person into a market or deterring or preventing a person from engaging in competitive conduct? There may be a distinction between predatory price cuts and defensive price cuts. In the absence of direct evidence, the prohibited purpose may be inferred.[61]

Predatory pricing : Subs46(1AA)

The following matters will need to be considered in assessing whether below cost pricing contravenes subs 46(1AA):

- **Substantial market share**

Did the respondent have *substantial market share* at the time of the intense price competition? No guidance is provided as to what constitutes a 'substantial share of a market'. This is potentially a low threshold, when compared with the substantial market power threshold in subs 46(1). In determining what is a 'substantial' market share the only requirement is that the court may consider the number and size of the respondent's competitors in the market.[62] This suggests that it is necessary to consider not just the absolute size of the market share but the size relative to that of the next largest competitors. Thus, if the respondent has a market share of 20% this may be substantial if the next largest competitor has a market share of only 2%, but a market share of 20% may not be substantial if another competitor has a market share of 80%. Alternatively, if there are five competitors in a market each with a market share of 20 % they may all be found to have substantial market shares.

The requirement of a substantial market share is likely to be more easily satisfied than that of substantial market power. Market share is only one factor in considering whether a corporation has market power. The key question is the height of barriers to entry. An assessment of the substantial market power standard requires an analysis of the structure of the market and, in particular barriers to entry, over the longer term. A substantial market share analysis is assessed at a particular point in time, namely, when the conduct at issue occurred.

- **Selling at less than relevant cost for a sustained period**

[61] Subs 46(7).
[62] Sub-s 46(1AB).

Did the respondent supply goods or services, or offer to supply goods or services for a sustained period at a price that is less than the relevant cost to the corporation of supplying such goods or services? The issues surrounding the appropriate measure of cost are the same as those already identified in relation to subs 46(1) above.

There is no need to prove that the respondent was 'taking advantage' of its substantial market share.

- **Prohibited purpose**

Did the defendant have a subjective *purpose* of eliminating or substantially damaging a competitor, preventing the entry of a person into a market or deterring or preventing a person from engaging in competitive conduct? Because there is no 'taking advantage' element in the new subs 46(1AA), much greater importance will be placed on the 'purpose of the below-cost pricing. Sub-section 46 (7) does not include a reference to subs 46(1AA). It would seem that because of the increased importance to be placed on purpose in the new provision, that direct evidence of purpose is required and that the prohibited purpose cannot be inferred form the surrounding circumstances.

Soon after subs 46(1AA) was enacted the Chairman of the ACCC sought to dispel any fear that subs 46 (1AA) would discourage price discounting by more efficient competitors:

> a more efficient business selling at a price that is above its cost, but below the cost of a competitor, is not a violation of the Act. Competitive markets are designed to encourage efficient firms to prosper and deliver benefits to consumers – not to inhibit their ability to do so. Competition encourages firms with higher cost structures to compete on non-price elements – to innovate or to offer niche products or to use different marketing or organisational approaches to deal with their cost disadvantage.[63]

Evidence of business reasons for conduct is admissible as indicative of purpose. But how are the courts to weigh the legitimacy of business reasons where the legitimate business reason (realising efficiency) necessarily involves harm to a competitor? Competitors will inevitably be hurt by hard competition.

As Mason CJ and Wilson J observed in *Queensland Wire*:

> Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to "injure" each other in this way.

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[63] Samuel G, "Promoting competition or protecting consumers – the role of competition policy and its implications for Australian businesses" John Curtin Institute of Public Policy Forum, Perth, 12 October 2007, p 10 available on the ACCC's website at: www.accc.gov.au

> This competition… and these injuries are the inevitable consequence of the competition s 46 is designed to foster. [64]

It would seem that corporations with a substantial market share can meet genuine competitive offers and that they are not expected to stand aside and lose customers to their smaller rivals. However, meeting a competitor's prices is unlikely to be accepted as a defence if it leads to pricing below average avoidable cost or average variable cost.[65]

2008 AMENDMENTS: TAKING ADVANTAGE

One of the purposes of the *Trade Practices Legislation Amendment Act 2008* is to clarify the meaning of 'take advantage' in s 46 which gives effect to a recommendation of the 2004 Senate Inquiry Report. The 2008 Act inserts after subs 46(6) a new subs (6A) which sets out a non-exhaustive list of matters that the court may have regard to in determining whether the respondent has 'taken advantage 'of its market power.

It provides:

> In determining for the purposes of this section whether, by engaging in conduct, a corporation has taken advantage of its substantial degree of power in a market, the Court may have regard to any or all of the following:
>
> (a) whether the conduct was materially facilitated by the corporation's substantial degree of power in the market;
>
> (b) whether the corporation engaged in the conduct in reliance on its substantial degree of power in the market;
>
> (c) whether it is likely that the corporation would have engaged in the conduct if it did not have a substantial degree of power in the market;
>
> (d) whether the conduct is otherwise related to the corporation's substantial degree of power in the market.
>
> This subsection does not limit the matters to which the Court may have regard.

This amendment follows a recommendation of the Senate Economics References Committee that the TPA 'be amended to include a declaratory provision outlining the elements of "taking advantage" for the purposes of s 46(1).'[66] The recommendation stated that the new provision should be based

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[64] *Queensland Wire* (1989) 167 CLR 177, 191

[65] See the Report of U.S. Department of Justice, *Competition and Monopoly: Single-firm Conduct Under s 2 of the Sherman Act* issued on 8 September 2008 at 69-71, available at the Department's website at: http://www.usdoj.gov/atr/public/reports/236681/pdf. The Department does not accept a defence of pricing below cost to meet competition.

[66] Senate Inquiry Report, p15.

on the wording put forward by the ACCC and set out at [2.28] of the Senate Committee Report.[67]

It is unclear whether this clarification merely seeks to codify the existing case law as part of the section, or to extend it. While elements (a), (b) and (c) reflect the tests developed by the Courts to establish the necessary link between the conduct and the respondent's market power, element (d) is new. Is the test for relatedness the same as (a), (b) and (c) or does it mean something else? If it means something else, then what degree of 'relatedness' is required?

This problem has already been encountered in relation to s 51(3) of the TPA which creates a partial exemption for conditions in licences and assignments of intellectual property rights. Conditions in licences or assignments of intellectual property rights are exempt only to the extent to which they 'relate to' certain subject matter.

The wording is unclear since it gives no indication as to the nature of the relationship which must exist before the exemption applies.[68]

If the words 'otherwise related to' in (d) are considered in the statutory context of the other elements (a), (b) and c), a court may conclude that a direct and material link between the conduct and the respondent's market power is required, rather than any link, however indirect or tenuous.

However, if a judge interpreting subs 46(6A) were to have regard to the policy objectives of fairness and small business protection, then there may be a greater preparedness to expand the scope of s 46 and find that subs 46(1) has been contravened on the basis of a much weaker link between the conduct and the respondent's market power.

At hearings before the Senate Inquiry, the Law Council of Australia argued against the ACCC's amendment claiming that it had the potential to 'remove the filter in s 46 which requires a link between the conduct and the market power'.[69] The Senate Committee considered that

> the ACCC's proposals, despite the views expressed by the Law Council of Australia, would make clear and explicit the requirement that a link be established between proscribed conduct and the possession of substantial market power.[70]

The proposed subs 46(6A) does not limit the matters that the court may have regard to, so that a court may have regard to whether the conduct can be explained in terms of securing efficiencies of scale or scope that are not available to smaller competitors.

CONCLUSION

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[67] Senate Inquiry Report, p14.
[68] See *Transfield Pty Ltd v Arlo International Ltd* (198) 144 ALR 83 at 102-103 (Mason J).
[69] Senate Inquiry Report, p14 at [2.30].
[70] Senate Inquiry Report, p15 at [2.31].

The *Trade Practices Legislation Amendment Act 2008* (Cth) made a number of significant changes to s 46 including those clarifying the meaning of key concepts such as 'substantial market power' and 'taking advantage', and the relevance of cost-based tests and recoupment for allegation of predatory pricing. But it is perhaps most famous for what it did *not* achieve, namely, putting an end to the uncertainty in the current drafting of the predatory pricing prohibition in subs 46(1AA), and aligning it with the long-standing prohibition in subs 46(1).

In reluctantly accepting the Senate's amendments to the Trade Practices Legislation Amendment Bill 2008 relating to subclause 46(1AA), the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP stated that the government would continue to monitor its effectiveness and reserved the right to revisit the issue in the future if it had unintended consequences.[71]

Prior to the *Trade Practices Legislation Amendment Act (No 1) 2007*, the courts indentified the policy objective of subs 46(1) as the protection of the competitive process for the benefit of consumers, rather than the protection of small business. Safeguarding the competitive process ensures that sellers provide the goods and services that buyers want, at the lowest prices.

The small business protection approach adopted in relation to subs46(1AA) – making it easier for small firms to challenge the market conduct of larger firms – weakens the incentive to compete on the basis of price or to realise efficiencies which could result in lower costs being passed on to consumers in the form of lower prices. The promotion of social and political objectives, such as small business protection should be the subject of a separate legislative regime such as Pt IVA of the TPA.

[71] Hansard (House of Representatives) 16 October 2008, p10.